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Mr. Gerard Poliquin
Secretary to the NCUA Board
1775 Duke Street
Alexandria, VA 22314

May 27, 2014

Re: Proposed Rule on Risk Based Capital RIN 3133-AD77

May 27, 2014

Dear Mr. Poliquin,

As President and Chief Executive Officer, of Sun East Federal Credit Union, I would like to take this opportunity to comment on the proposed Risk Based Capital rule. My credit union board of directors, supervisory committee, staff and members join with credit unions across Pennsylvania and around the country to add our voices to the 320 members of Congress in expressing our genuine concerns over this issue.

There are a number of issues that we wish to specifically comment on:

Examiner Discretion Provision

We believe that the Examiner Discretion provision should be removed. It is absolutely essential that credit unions understand clearly and objectively what their capital and net worth expectations will be. This proposed rule already creates a dual system with statutory net worth requirements under PCA as being 7% of total assets to be well capitalized and 10.5% of risk weighted assets to be well capitalized. Within itself, this creates a question of which is the more



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important of the two ratios and which should have the strategic priority in credit union risk management decisions – building net worth ratios through the earnings that come with managed risk of certain higher risk assets or building capital ratios through divestiture of certain higher risk assets that might be performing well but adversely impact the risk-based capital ratios.

Unfortunately, this proposal, provides for even yet another unknown variable for a credit union to consider when trying to figure out the right net worth versus capital ratio mix – examiner discretion.

It is our understanding that under this proposal, an examiner can increase (not decrease, only increase) a credit union's individual risk-based capital requirement by subjective action during an examination based upon the examiners determination of the need for additional capital versus his or her assessment of the balance sheet risk.

In other words, a credit union with 9% net worth under PCA and a 13% risk-based capital ratio can have their confidence of being in solid regulatory compliance shattered by an individual examiner's decision that – based upon the examiner's determination of potential balance sheet risk (in the interest rate risk category, for example, to use a current hot topic examination focus) – the credit union needs 14.50% risk-based capital.

The lack of management clarity this provision imposes into the system is, in our view, a serious flaw that undermines the effectiveness of the entire regulation and turns it into an unbridled extension of examiner subjective authority. This provision effectively leaves the risk-based weighting process outlined in the regulation as a mere guide from which examiners can use as their starting point in perhaps requiring additional capital and, if not complied with, imposing corrective actions on the credit union without reasonable appeal options.

Supplemental Capital

We believe that Supplemental Capital should be included. Recognizing that there are legitimate differences among credit unions as to whether supplemental capital options should be authorized for credit unions (beyond retained earnings as the sole source of credit union capital), the reality is that NCUA's own low-income designation initiative has now made over 2,000 credit unions eligible for supplemental capital to count toward its statutory net worth requirements of 7% of total assets to be considered well capitalized under existing law and regulation.

Combine this with the fact that there is no law or regulation preventing supplemental capital from being considered for all credit unions under the proposed risk-based capital requirements this rule seeks to implement and it seems that this regulation is an excellent opportunity for NCUA to draft and put into the final regulation the guidelines and specifications for credit unions to supplement their capital (and, in the case of the 2,000+ low income designated credit

unions, their net worth) with subordinated debt or some other conservative capital building option.

A supplemental capital regulation is needed. In fact, it will be impossible for NCUA to avoid it now that over 2,000 credit unions are eligible for supplemental capital – regardless of whether it is included as an option under this new risk-based capital proposal.

The NCUA needs to define acceptable parameters, consistent with GAAP, for supplemental capital. Now is the opportune time to do so. This regulation would be the right vehicle.

Capital Restoration Plan Should Be The Sole Default Requirement For A Credit Union Below 10.5% Risk-Based Capital But Over 7% Net Worth Of Total Assets.

If a credit union has over 7% net worth as a percentage of total assets, its failure to exceed the 10.5% threshold of risk-based capital should not trigger corrective actions by the NCUA such as removal of officials or divestiture of assets.

The default requirement for a credit union with over 7% net worth but less than 10.5% risk-based capital should be submission of a capital restoration plan that would seek to bring the risk-based capital ratio into compliance with the 10.5% requirement within a reasonable period of time. For some credit unions, that might be one year. For others, it could take three years or longer.

The key differentiator here is that, without the risk-based capital regulation, these credit unions have fully complied with existing law and regulation in building over 7% net worth as a percentage of their total assets.

Rather than dismissing boards and replacing management teams that were otherwise in compliance building net worth at the highest standards expected by law, these credit unions should be given the opportunity to build a capital plan that can work for their individual credit unions and a reasonable period of time to come into compliance with the new regulation without sacrificing earnings unnecessarily or without an appropriate period of time in which to do so.

CUSO Investments Should Be Weighted At 1.0 And Managed Through The Supervisory Process Of Credit Unions, Not An Arbitrary Weight Of 2.5 That Could Stifle Risk Sharing And Collaboration.

NCUA enacted a new CUSO rule in 2013 that sought to gather additional data on credit union CUSO investments because the agency did not feel comfortable it had a good handle on the amount of risk CUSOs bring to the credit union system.

Interestingly, even though the agency admitted only months ago the lack of available empirical data on potential CUSO risk, the risk weight applied to CUSO investments in this proposed rule

is the absolute highest risk weighting applied to any asset. CUSO investments are weighted; quite arbitrarily it would seem from the admitted lack of agency data, at \$2.50 for every dollar of investment.

Even though there were a couple of high profile credit union losses partially driven by bad CUSO investments (Texans and Telesis), the reality remains that the overwhelming majority of CUSOs are performing very well, generating considerable savings through economies of scale and providing much needed non-interest income to their credit union owners. Demonstrating the credit union cooperative spirit at its finest, they foster much-needed innovation in the marketplace through shared risk and collaboration. CUSOs have been one of the credit union industry's greatest success stories of the past ten to twenty years – see CO-OP, PSCU, CUDL, CU Revest, NB Risk Partners and too many other great CUSO examples to name.

Unless the risk weighting is made more appropriate to reflect the actual historical performance and lack of risk in CUSO investments (less than 22 basis points of credit union assets are invested in CUSOs, hardly a systemic risk), this risk-based capital proposal has the very real potential to bring a real chilling effect on CUSO investment and, through that lack of investment, a restriction on what has become major credit union earnings driver and collaborative savings source.

To be sure, credit union examiners can already gain the data they need from the credit unions that own CUSOs. From this data and working through the credit unions they supervise, the regulators can ensure CUSO return on investment is appropriate to the risk through the examination and supervisory process. A punitive risk weighting that is not commensurate to the risk is simply not appropriate and could have serious unintended consequences of driving many credit unions to sources outside the system where there is even less supervisory control through the credit union owners.

The risk weight of CUSO investments should be set at 1.0 – dollar for dollar. Exceptions that are likely to cause potential credit union risk should be managed, not through an unjustifiable arbitrary risk weighting, but instead through the credit union examination and supervision process on a case-by-case basis.

Mortgage Loan Servicing Weight Of 2.5 Is Excessive.

In 2013, the NCUA finalized a rule on loan participations that was intended to help credit unions (and, through the provisions of the new rule when complied with by credit unions, NCUA itself) better manage the potential concentration risk in loan participations.

Rather than give its own rule a chance to work and bring less concentration risk, the risk weighting within this proposed rule at 2.50 is artificially high. The high risk weighting seems to

send a regulatory preference by NCUA that there be less loan participations and less CUSO development.

From a risk sharing and collaborative viewpoint, this seems short-sighted. Recognizing that this is the primary class of assets the Basel III capital accords for community banks weights above 100% we see that there is some additional risk here and a more appropriate approach in our view would be to set the risk weights in this area closer to 1.5 than 2.5. And the recourse factor should be brought into the picture in determining the weight, perhaps allowing an even lower weighting (1.0 for example) if the loans are sold without recourse but serviced

Paid-In Capital To A Corporate Credit Union Should Be Weighted At Less Than 2.0.

The corporate credit unions have had more regulatory changes over the past five years than any other sector of the credit union system including additional capital requirements, stricter investment limits, more concentration risk prohibitions, governance changes and a much larger examination department with expanded authority to take corrective action.

Most would agree that these regulatory changes have made the corporate credit unions less risky for credit union investment.

Then why count paid-in capital investment in a corporate credit union (a source of capital building that NCUA has encouraged and counted upon to strengthen the corporates following the recent crisis and through the new rules) at twice as risky as a dollar's investment in a mortgage loan in excess of 35% of assets?

While paid-in capital is certainly more risky to some degree than member capital at a corporate credit union, the assigned weight seems excessive and again provides a disincentive to credit unions investing in their corporate credit unions – at a time when corporate credit unions are working hard each day to build the capital necessary to comply with the new corporate rules.

Paid-in capital, in our view, would be more appropriately weighted at 1.25. This would provide recognition of some additional risk but would also recognize that the corporate credit union structure has gone through a total overhaul with new regulatory requirements. These new regulatory requirements have paid-in capital as a major component to protect credit unions and the share insurance fund.

A proper weight to paid-in capital to corporate credit unions is needed for both natural person credit unions and corporate credit unions – not to mention the share insurance fund.

Effective Date Of Final Rule Implementation Should Be A Minimum Of 60 Months.

Since it will likely take the entirety of 2014 and perhaps into early 2015 before a final risk-based capital rule can be approved by the NCUA Board (the possibility of a second, or maybe third, comment period is not unprecedented on such a far-reaching proposal – see Basel III in the banking industry), there should be five-year period allowed for credit unions to get ready for its implementation.

Nothing impacts the strategic planning of a credit union more than the net worth and capital requirements necessary to be both a safe and sound institution and to be in full compliance with all statutory and regulatory requirements regarding capital. It will take time for credit unions to adjust their balance sheets related to this new regulation.

Earnings will have to be balanced with the risk weighting of the assets necessary to build the earnings. Some investments will have to be shortened. Some loans will have to be divested – or at least the position in those loan categories adjusted.

Some of the questions raised previously such as which is the primary ratio credit unions should manage to and what will the corrective action requirements if one is met while the other is not – will need to be clarified through Letters to Credit Unions and Supervisory Guidance.

Credit unions need a minimum of five full years to prepare for this regulation once it is finalized. A delayed effective date until the end of year 2020 is essential.

In conclusion, no one wants to see risk-based capital fail. However, the NCUA and federally insured credit unions would be best served, in our view, by withdrawing the current proposal and starting anew to create a more balanced and workable risk-based capital rule for both credit union viability and NCUA's regulatory purposes. In the end, a *balanced* risk-based capital rule could make the credit union system safer, sounder and better positioned to compete than at any time in its history. This proposal is not balanced.

Thank you for your consideration.

Sincerely,



Michael J. Kaczinski
President & CEO

CC: SEFCU Board of Directors
SEFCU Supervisory Committee
SEFCU Executive Management